80-1238

No.

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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1980

JOSEPH A CAROTHERS, PAUL L. SCHMETZER, JOSEPH A. MUNGOVAN, DAVID E. FLANIGAN, Individually and as Representatives of a Class of Certain Shareholders and Stock Option Holders of CYBERNETICS & SYSTEMS, INC., A Delaware Corporation, - - - - - - - - - Petitioners,

versus

W. THOMAS RICE,
PRIME F. OSBORN,
CYBERNETICS & SYSTEMS, INC.,
L & N INVESTMENT CORPORATION,
LOUISVILLE AND NASHVILLE RAILROAD COMPANY,
SEABOARD COAST LINE RAILROAD COMPANY,
SEABOARD COAST LINE INDUSTRIES, INC. - Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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January 20, 1981

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QUESTIONS PRESENTED FOR REVIEW

The questions presented for review are whether the United States Court of Appeals for the Sixth Circuit erred in reversing the judgment of the United States District Court for the Western District of Kentucky, Gordon J., holding that the five year period of limitations applicable to state common law fraud action, rather than the three year period of limitations applicable to Kentucky Securities Act actions, should be "borrowed" and applied to the Federal claim based upon the facts in dispute where:

(a) This Court held, *Ernest & Ernst* v. *Hochfelder*, 425 U. S. 185 (1976) that an action under Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") requires proof of an intent to defraud ("scienter");

(b) An action under the Kentucky Securities Act, unlike those under Section 10(b) of the 1934 Act, or the Kentucky common law of fraud, does not require proof of an intent to defraud;

(c) The Kentucky Securities Act does not even provide a private remedy to individuals in the alleged position of the Petitioners, that is, to defrauded sellers of securities; and

(d) The Sixth Circuit Court of Appeals in *Nickels* v. *Koehler Management Corp.*, 541 F. 2d 611 (6th Cir., 1976) cert. denied 429 U. S. 1074 (1976) established the rule in the Sixth Circuit of applying longer, not shorter, periods of limitations.

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No.

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1980

JOSEPH A. CAROTHERS, PAUL L. SCHMETZER, JOSEPH A. MUNGOVAN, DAVID E. FLANIGAN Individually and as Representatives of a Class of Certain Shareholders and Stock Option Holders of CYBERNETICS & SYSTEMS, INC., A Delaware Corporation - - *Petitioners,*

v.

W. THOMAS RICE,
PRIME F. OSBORN,
CYBERNETICS & SYSTEMS, INC.,
L & N INVESTMENT CORPORATION,
LOUISVILLE AND NASHVILLE RAILROAD COMPANY,
SEABOARD COAST LINE RAILROAD COMPANY,
SEABOARD COAST LINE INDUSTRIES, INC. - *Respondents.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Joseph A. Carothers, Paul L. Schmetzer, Joseph A. Mungovan and David E. Flanigan, individually, and as representatives of a class of certain shareholders and stock option holders of Cybernetics & Systems, Inc., a Delaware Corporation, pray that a writ of certiorari issue to review the judgment of the United States

Court of Appeals for the Sixth Circuit entered in this case on September 15, 1980, petition for review and rehearing en banc denied on October 23, 1980.

OPINIONS BELOW

The memorandum opinion and order of the district court issued March 3, 1978 is unreported and a copy is attached hereto in the Appendix at pp. 42-45.

The opinion of the Unites States Court of Appeals for the Sixth Circuit is reported at 663 F. 2d 7 (6th Cir., 1980) and a copy of the opinion is attached hereto in the Appendix at pp. 46-68.

JURISDICTION

An opinion and order overruling Respondents' motion to dismiss the allegations of Petitioners' complaint directed to Federal Securities law violations for lack of jurisdiction for failure to assert the Federal claim within the period of limitations provided by the Kentucky Revised Statutes was entered by the United States District Court for the Western District of Kentucky (James Gordon, Jr.), on March 3, 1978.

On September 15, 1980, the United States Court of Appeals for the Sixth Circuit reversed to judgment below. Motion for rehearing en banc was requested by Petitioner and was denied on October 23, 1980. No extension of time within which to petition for certiorari was sought.

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

CONSTITUTIONAL PROVISIONS, TREATIES, STATUTES, ORDINANCES, AND REGULATIONS INVOLVED

This case involves the Securities Exchange Act of 1934; 15 U.S.C. §78a et seq.; Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5; Kentucky Revised Statutes Chapter 292; Kentucky Revised Statutes Section 413.120.

Pertinent portions of the above-referenced statutes and rules are reproduced in the Appendix hereto.

STATEMENT OF THE CASE

Joseph A. Carothers, Paul L. Schmetzer, Joseph A. Mungovan and David E. Flanigan, individually and as representatives of a class of shareholders and stock-option holders of Cybernetics and Systems, Inc., a Delaware Corporation, filed the Complaint in this action, in the United States District Court for the Western District of Kentucky, on February 11, 1977. The Petitioners sought compensatory damages, or in the alternative, rescissionary relief, and punitive damages against Cybernetics and Systems, Inc (''Cybernetics''), certain corporations that control Cybernetics (Louisville and Nashville Investment Corporation; Louisville & Nashville Railroad Company; Seaboard Coast Line Railroad Company and Seaboard Coast Line Industries, Inc.) and certain controlling persons and Directors of those Corporations (W. Thomas Rice and Prime F. Osborn) arising out of Cybernetics' 1973 tender offer for, and its purchases of, its stock and stock

options from the Petitioners and from the class which they represent. The Complaint contains three Counts, the First Count grounded upon violations of the Federal Securities Laws, the Second Count grounded upon violations of the Kentucky common law of fraud and the Third Count grounded upon violations of state fiduciary common law.

The individual Petitioners are among a group of persons alleged by the Complaint to have been defrauded by improper acts and omissions of the Respondents occurring when the Respondents purchased, and coerced Petitioners into selling back to Cybernetics, the Cybernetics stock and stock options owned by them. The details of Respondents' fraudulent plan and actions are as follows:

In 1968, the Louisville and Nashville Railroad Company ("L & N") recognized the need for a computerized ability to account for and direct its equipment and offices throughout the United States. Also, L & N desired to offer computer services to the general public to generate additional revenues for L & N. As a result, in 1969, L & N caused Cybernetics to be incorporated to perform these functions and thereafter offered the Petitioners employment and stock options to participate in organizing, directing and operating Cybernetics. Louisville and Nashville Investment Corporation ("L & N Investment"), a subsidiary of L & N, originally capitalized Cybernetics and always owned at least 85% of its outstanding stock. The Respondents represented to prospective employees and stock-option holders (Petitioners) that it was Respondents' inten-

tion that at some time in the future, internal and public operations having achieved a sufficient level, Cybernetics would effect a public distribution of its securities to the public and that Petitioners could then re-sell their shares to the public at a profit. In order to continue to attract and retain competent, experienced personnel, Respondents continuously caused Cybernetics to offer stock options to its employees and prospective employees.

At the time of Cybernetics' formation, Respondent Rice expressed strong opposition to the sale of its securities to employees. At that time, Rice was President of Seaboard Coast Lines Railroad Company ("Seaboard") which owned at least 35% of the outstanding stock of L & N, and he also served as an L & N Director.

In 1971, Seaboard acquired 100% of the outstanding stock of L & N, thereby acquiring control of Cybernetics, which was 80% owned by L & N Investment and had approximately forty employees who were option and security holders.

In 1973, Rice directed that the Respondent Corporations consolidate 100% of the stock ownership of Cybernetics into L & N Investment. As a result, at the direction and control of the Respondents, Cybernetics was caused to effect a tender offer for its own shares from its shareholders and stock-option holders at the grossly inadequate price of Twenty ($.20) Cents per outstanding share and Fifteen ($.15) Cents per outstanding stock option. The core of Petitioners' Complaint is that the means and manner by which this tender offer was effected violated the Federal Securi-

ties Laws, state laws of common law fraud and state fiduciary law. The Respondents first restricted the business operations of Cybernetics, and improperly and misleadingly manipulated its financial affairs, all to make it appear that Cybernetics was financially unstable and unproductive. Thereafter, the Respondents fraudulently coerced Cybernetics' shareholders and option holders into tendering and selling their shares back to the Corporation at a price which the Respondents knew to be below the fair market value of such securities. The Respondents effected the tender offer by means of documents and information which they knew did not adequately present a historical or current picture of Cybernetics' financial status or prospects. The tender offer began in February, 1973, and was completed on May 18, 1973.

Many of the employees, stockholders and option holders of Cybernetics resigned their employment in the period following the expiration of the tender offer in May, 1973. However, as a result of continuing communication among the named Petitioners, the Complaint in this action was filed on February 11, 1977, demanding compensatory and punitive damages for the wrongs done to the Petitioners and the class which they represent.

Federal jurisdiction over the Petitioners' Federal Securities Law claim is based upon Section 27 of the Securities Exchange Act of 1934 (15 U.S.C., §78aa). Federal jurisdiction over the Petitioners' state common law fraud and fiduciary duty claims, is based upon the doctrine of pendent jurisdiction.

The various motions filed against the Complaint assert, in essence, that the Federal Securities Law Count is barred by limitations. Since the 1934 Act provides no limitations period for the implied right of action under Section 10(b), a Federal Court sitting in such an action will apply the most analogous state statute of limitations. *Holmberg* v. *Armbrecht,* 327 U. S. 392 (1946), *Ernst & Ernst* v. *Hochfelder,* 425 U. S. 185 (1976). In this litigation, the choice is between the three year period of limitations established under the Kentucky Securities Act (Kentucky Revised Statutes, Section 292.480(3)) and the five year period of limitations applicable to actions for common law fraud and to statutory actions where no other time is fixed by the statute creating the liability (Kentucky Revised Statutes, Section 413.120(12) and (2) respectively).

The District Court held that an action for breach of the Kentucky common law of fraud, rather than an action under the Kentucky Securities Law, was more analogous to the Federal Securities action implied under Section 10(b) of the 1934 Act. The District Court considered it significant that the Civil Remedies Section of the Kentucky Securities Law (KRS 292.480), by its express terms, provides no remedy to a defrauded seller of securities, and that the consistent position of the United States Court of Appeals for the Sixth Circuit is that it is more appropriate to apply the states' longer limitations periods.

Following Respondents' Motion for Reconsideration to the District Court, that Court reaffirmed its

position but, under 28 U.S.C. §1292(b), certified the question of its choice of the five year period of limitations to the Court of Appeals for the Sixth Circuit. The Court of Appeals permitted interlocutory appeal of the question, briefs were filed by the parties and oral arguments were heard upon the matter. On September 15, 1980, the Court of Appeals panel reversed the decision of the District Court, with a dissent to that reversal being filed by one of the Judges on the panel.

The Court of Appeals ruled that a civil remedy for a seller of securities would be implied to exist under KRS 292.320(1), even though (1) the Kentucky Courts have not addressed this issue; (2) a specific Civil Remedies Section is provided in the Kentucky Securities Act for securities fraud actions and it is expressly limited to defrauded securities purchasers; and (3) implication is not appropriate because defrauded sellers already have a remedy available to them under the Kentucky common law of fraud. The Court of Appeals went one step further and ruled that an implied remedy being thus available, the short limitations period of KRS 292.480(1) would be applicable to that state-implied action. This was without direct dicussion of the extremely pivotal issue of the concomitant applicability of the KRS 292.480(1) decreased evidentiary burdens (expressly limited to a defrauded purchaser) to the seller's implied right of action under KRS 292.320(1).

The Court of Appeals also ruled that the Federal action more closely resembles the implied state action under KRS 292.320(1), even though previous decisions of that Court had ruled that the broad remedial

policies of the Federal Securities Laws are better served by a longer, not a shorter, limitations period. *I.D.S. Progressive Fund, Inc.* v. *First of Michigan Corp.*, 533 F. 2d 340 (6th Cir. 1976). The longer period would be available in Kentucky to a defrauded securities seller suing under the Kentucky Common law of fraud.

On October 23, 1980, the Court of Appeals denied Petitioner's Motion for a Rehearing *en banc* on their decision of September 15, 1980.

REASONS FOR GRANTING THE WRIT

I. Review is Necessary to Resolve a Conflict Between Federal Circuits on an Important Issue of Federal Securities Law Requiring a Uniform Judicial Standard.

The subject action is grounded upon allegations of breaches of Federal Securities Laws and of state common law. Petitioners assert violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, basing their Federal claim upon the now well-established implied right of action under those provisions. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 404 U. S. 6 (1971).

It is equally well settled that, there being no express Federal statute of limitations to be applied to actions under these provisions, the Federal Courts are to utilize the limitations period of the forum state which is applicable to the state action which most resembles the federal action asserted. *UAW* v. *Hoosier Cardinal Corp.*, 383 U. S. 969 (1966).

In similar actions, the various District and Circuit Courts have taken opposite views with respect to whether to apply the state limitations period applicable to common law fraud or to state securities actions. In Kentucky, the limitations period for common law fraud is five (5) years (Kentucky Revised Statutes Section 413.120(12)) and the period for Kentucky securities law fraud is three (3) years (Kentucky Revised Statute Section 292.480(3)).

As stated in *UAW* v. *Hoosier Cardinal Corporation, id.*, the Federal Court, in choosing the applicable state limitations period, should look (1) to the period which is substantially closest to the federal statute, and (2) to the period which best effectuates the policies behind the federal statute. In applying these standards to previous actions arising out of other states within the Sixth Circuit, that Court of Appeals has applied the limitations period applicable to common law fraud actions of the particular state. *Nickels* v. *Koehler Management Corp.*, 541 F. 2d 611 (6th Cir., 1976), cert. denied 429 U. S. 1074 (1976); *IDS Progressive Fund, Inc.* v. *First of Michigan Corp.*, 533 F. 2d 340 (6th Cir. 1976). This conforms to the position taken by certain other Circuits, including the First, Second, Third, Ninth and Tenth.[1] Other Circuits, using the same standards, have applied the period of limitations ap-

[1] *Cooke* v. *Avien, Inc.*, 573 F. 2d 685 (1st Cir. 1978); *Stull* v. *Bayard*, 561 F. 2d 429 (2nd Cir. 1977), cert. denied 434 U. S. 1035 (1977); *Roberts* v. *Magnetic Metals Company*, 611 F. 2d 450 (5th Cir. 1979); *United California Bank* v. *Salik*, 481 F. 2d 1012 (9th Cir. 1973); *Mitchell* v. *Texas Gulf Sulphur Company*, 446 F. 2d 90 (10th Cir. 1971), cert. denied 404 U. S. 1004 (1971).

plicable to state blue sky law actions, including the Fourth, Seventh, Eighth and the District of Columbia Circuit.[2] It is unclear what particular period of limitations is to be applied in the Fifth Circuit.[3]

It is asserted that this difference of positions between the Circuits as to the appropriate limitations period arises from a difference in the Circuits' interpretations of the test to be applied, rather than from differences among the various state laws setting forth the components of the state actions. And this conflict gives rise to the application by the different Circuits of unequal burdens and standards in actions asserting violations of Section 10(b).

In arriving at their conflicting positions, the Circuits generally assume two approaches: (1) to consider the various factors, or elements, of each state cause of action with a view to determining which state claim would best effectuate and most "resemble" the elements of the Federal claim; or, (2) to broadly consider the commonality of purposes of the state and federal causes of action, rather than dissecting the factors and elements of each, with a view to determining the "similarity" of actions.

Those Circuits considering the purpose of the state statutes have generally concluded that because the Federal and state securities laws are for the com-

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[2] *O'Hara* v. *Kovens*, 625 F. 2d 15 (4th Cir. 1980); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F. 2d 123 (7th Cir. 1972); *Vanderboom* v. *Sexton*, 422 F. 2d 1233 (8th Cir. 1970); *Forrestal Village, Inc.* v. *Graham*, 551 F. 2d 411 (D.C. Cir. 1977).

[3] *Roberts* v. *Magnetic Metals Company*, 611 F. 2d 450 (5th Cir. 1979).

mon purposes of regulating securities matters and actions, the state securities law cause of action most "resembles" the Federal claim. But a significant number of the Circuits considering the different detailed elements of the state and Federal actions have concluded that, in terms of actual proof burdens and allowable recovery limitations, the state common law fraud actions most "resemble" the Federal claim.[4]

In the pre-*Hochfelder* decisions, the Courts analyzing the actions' elements generally considered it important that an action under state securities laws and under Section 10(b) of the 1934 Act did not require proof of "scienter", while an action under state common law fraud did.[5,6] But since the *Hochfelder* decision, the Circuits are also split upon the ultimate effect of this change in this important proof element of a 10b-5 action. Some Federal Courts hold that, though a state securities law action does not require proof of "scienter", while an action under Section 10b-5 and common law fraud would, this is not sufficient to tip the scale of resemblance factors to the fraud

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[4]*In re: Alodex Corporation Securities Litigation*, 533 F. 2d 372 (8th Cir. 1976); *Schaefer* v. *First National Bank of Lincolnwood*, 509 F. 2d 1287 (7th Cir. 1975), *cert. denied*, 425 U. S. 943 (1976); *Hudak* v. *Economic Research Analysts, Inc.*, 499 F. 2d 996 (5th Cir., 1974), cert. denied, 419 U. S. 1122 (1975); *Mooney* v. *Tallent*, 397 F. Supp. 680 (N.D. Ga. 1975).

[5]*Vanderboom* v. *Sexton*, 422 F. 2d 1233 (8th Cir., 1970); *In re: Alodex Corporation Securities Litigation*, 533 F. 2d 372 (8th Cir. 1976); *Kramer* v. *Loewi & Co., Inc.*, 357 F. Supp. 83 (E.D. Wisc. 1973).

[6]The term "scienter" refers to a mental state embracing intent to deceive, manipulate or defraud. *Hochfelder, supra.*

action.[7] Other Federal Courts have determined just the opposite, giving significant weight to this change.[8]

This then is the two-pronged conflict in the positions of the Circuits. That is, the Circuits differ as to what tests or analytical factors are to be considered and utilized in determining the particular state limitations period to be applied to the Federal action and the Circuits also differ in their positions as to the weight and effect of the *Hochfelder* determination that "scienter" must now be proven by Plaintiffs in Section 10(b) actions.

And since it is necessary that a limitations period be "borrowed", it is imperative that this Court resolve the conflicts between the Circuits to provide consistency and direction to the Circuits in their application of the "resemblance" test.

II. The Decision Below is Erroneous in View of the Effect of the *Hochfelder* Decision by This Court.

This Court in *Hochfelder, supra,* effectively converted Section 10(b) of the Securities Exchange Act of 1934 from a negligence-and-fraud statute to a fraud-only statute. In those cases where a Federal Court is

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[7] *Forrestal Village, Inc.* v. *Graham,* 551 F. 2d 411 (D.C. Cir. 1977); *O'Hara* v. *Kovens,* 625 F. 2d 15 (4th Cir. 1980); *Morris* v. *Stifel, Nicolaus & Co., Inc.,* 600 F. 2d 139 (8th Cir. 1979); *Osterneck* v. *E. T. Barwick Industries Inc.,* 79 F.R.D. 47 (N.D. Ga. 1978).

[8] *McNeal* v. *Paine, Weber, Jackson & Curtis, Inc.,* 598 F. 2d 888 (5th Cir. 1979); *Campito* v. *McManus, Longe, Brockwehl, Inc.,* 470 F. Supp. 986 (N.D. N.Y. 1979); *First Federal Savings and Loan Association of Miami* v. *Mortgage Corporation of the South,* 467 F. Supp. 943 (N.D. Ala., 1979).

considering both a state securities statute patterned after the Uniform Securities Act and a general common law fraud statute, Petitioners assert that the *Hochfelder* decision is dispositive of the issue of resemblance. That is, in those instances where the forum state bases state securities law actions on negligence, and where common law fraud actions are based upon proof of "scienter", the Federal Section 10(b) action is an analogue to the state common law fraud action. Therefore the state limitations period applicable to common law fraud should be "borrowed" for the Federal action.

If the reduced procedural restrictions applicable to Kentucky Securities Law actions were comparable to those applied in Section 10(b) actions, then it might be appropriate to apply the shorter Kentucky securities limitations period. But they are not. And as this Court has impliedly indicated, since the procedural restrictions do not exist for a Section 10(b) action, the reason for the shorter limitations periods like those of the Federal Securities Acts is obviated. *Hochfelder, supra* at page 209. And since a Section 10(b) action almost exactly parallels a Kentucky common law fraud action (i.e., without lessened procedural restrictions but still requires proof of "scienter"),[9] the common law fraud limitations period should be "borrowed" and held applicable in the case at bar.

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[9]*Keck* v. *Wackers*, 413 F. Supp. 1377 (E.D. Ky. 1976); *Sanford Construction Co.* v. *S & H Contractors, Inc.*, Ky., 443 S. W. 2d 227 (1969).

III. The Decision Below is Erroneous in Determining That a Defrauded Seller has a Cause of Action Available Under Kentucky Securities Law.

In the decision from the Court of Appeals below, it is necessary that a cause of action be found to exist for a defrauded seller under the Kentucky Securities Law before that cause of action can be compared to the asserted Federal claim for purposes of applying the "resemblance" test. And though the Kentucky Courts have never addressed the question, and though a Kentucky security-holder would have other remedy available to him under the Kentucky common law of fraud, the Court of Appeals still implied a defrauded seller's remedy under the Kentucky analogue to Rule 10b-5 (KRS 292.320(1)). This disregards the Civil Remedies Section of Kentucky Blue Sky Laws, which is expressly limited to defrauded buyers of securities, rather than sellers.

Even more, having determined that a remedy is to be so implied, the Court of Appeals applied the shorter limitations period of the Civil Remedies Section of the Kentucky Securities Law. Assuming arguendo that a defrauded securities seller has available an implied civil remedy under KRS 292.320(1), Petitioners assert that the period of limitations applicable to that implied remedy would not be that period set forth in KRS 292.480(3), because that limitations period with its lessened procedural restrictions is expressly limited to defrauded sellers. Petitioners assert that the defrauded seller's action instead would be similar to an

action under Kentucky common law fraud with the traditional burdens of proof. Therefore, the limitations period which would be applicable to the implied seller's remedy is the five-year period set forth in KRS 413.120(2) or (12).[10]

Since it is the Respondents themselves that are asserting the resemblance between the implied seller's remedy under KRS 292.320(1) in an action under Section 10(b), then Petitioners strongly assert that the state five-year limitations period of KRS 413.120 would be applicable to KRS 292.320(1) and would *also* be applicable to the Section 10(b) action.

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[10]KRS 413.120. The following actions shall be commenced within five (5) years after the cause of action accrued:

(1) . . .

(2) An action upon a liability created by Statute, when no other time is fixed by the statute creating the liability; . . .

. . .

(12) An action for relief or damages on the ground of fraud or mistake.

CONCLUSION

As long as state statutes of limitations must be borrowed for certain Federal securities actions, there can be no national uniformity as to the time period of limitations. However, there can and should be uniformity as to the test, and means of applying the test, in determining which state limitations period is to be borrowed. Only this Court can establish the standard which will bring about the desired consistency of results. Almost all Federal Circuits have now addressed the problem and the results are irreconcilable. The issue is ripe for resolution by this Court.

For these reasons, Petitioners respectfully request that their Petition for Writ of Certiorari be granted.

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January 19, 1981

APPENDIX

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY

Civil No. 77-0066-L(G)

JOSEPH A. CAROTHERS, ET AL.

v.

W. THOMAS RICE, ET AL.

MEMORANDUM OPINION AND ORDER—Filed November 7, 1977

John L. Carroll, Esquire, Evansville, Indiana, Lawrence L. Pedley, Esquire, Louisville, Kentucky, William T. Warner, Esquire, Louisville, Kentucky, and Robert P. Ross, Esquire, Louisville, Kentucky, Counsel for the Plaintiffs.

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Gordon, Senior United States District Judge.

This action was brought by Joseph A. Carothers, *et al.*, individually and as representatives of a class of certain minority stockholders and stock option holders of Cybernetics & Systems, Inc., [hereinafter, "Cybernetics"] against certain "control persons" of Cybernetics for damages and/or equitable relief arising out of violations of the Secu-

rities Exchange Act of 1934, as amended, 15 U.S.C.A. §78a *et seq.*, [hereinafter the "Exchange Act"]; the laws of the States of Delaware, Virginia, and Kentucky; and those state laws regarding the fiduciary responsibility of control persons and/or majority stockholders and corporate officers toward shareholders.

As for the federal claims, the plaintiffs allege violations of Section 10(b), 14(e) and 20 of the Exchange Act, 15 U.S.C.A. §§78j(b), 78n and 78t, and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. §240.10b-5.

This Court has jurisdiction of the federal claims pursuant to 15 U.S.C.A. §78aa and has pendent jurisdiction of the claims arising under the laws of the States of Delaware, Virginia and Kentucky.

These claims are before the Court on defendants' motions for dismissal pursuant to Rule 12(b)(6) of the Federal Rules of Civil Procedure. First, defendants argue that the plaintiffs' claims arising under the federal and state securities laws fail to state a claim upon which relief may be granted because they are barred by the applicable state statutes of limitation. Second, defendants argue that paragraphs 40(b), 41 and 42 of the original complaint of paragraphs 39(b), 40, and 41(a) of the amended complaint in essence represent a shareholder's derivation action and fail to state a claim upon which relief may be granted because, inter alia, they do not meet the technical requirements of Rule 23.1 of the Federal Rules of Civil Procedure. Third, defendants argue that the Court could not have subject matter jurisdiction over the pendent state claims in the event the federal claims are dismissed, therefore, they also should be dismissed.

Since matters outside the pleadings have been presented and are not excluded by the Court, the Motion shall be treated as one for summary judgment and disposed of as provided by Rule 56 of the Federal Rules of Civil Pro-

cedure. Fed. R. Civ. P. 12(c). Having carefully reviewed the voluminous memoranda of law submitted by the parties, the Court concludes that all parties have been given reasonable opportunity to present all material made pertinent to such a summary judgment motion. The Court also finds that the pleadings and affidavits show that there is no genuine issue as to any material fact surrounding the legal issues here decided.

Statute of Limitations Question

According to the affidavit of Robert C. Moore, General Attorney for the Louisville and Nashville Railroad, the defendants' tender offer expired on March 16, 1973 and all of the plaintiffs' stock and stock options were acquired by defendants not later than May 18, 1973. None of the plaintiffs held any shares or options of Cybernetics after May 18, 1973. No counter-affidavits were tendered by plaintiffs. Furthermore, plaintiffs have neither plead nor argued the federal doctrine of "tolling" with respect to the commencement of the period of limitation. Therefore, the Court finds that the statute of limitations commenced running no later than May 18, 1973. This suit was filed on February 11, 1977, more than three years after the claims arose.

There is no general federal statute of limitations and no provision in either Sections 10(b), 14(e), or 20 of the Exchange Act as well as SEC Rule 10b-5, although other sections of the Act have stated limitations. *See e.g.* 15 U.S.C.A. §§78i(e), 78p(b), 78r(c) and 78cc(b). Both parties agree that it is well settled that when Congress has created a federal right but has not prescribed a limitation period, federal courts will borrow the limitation period proscribed by the forum state. *International Union, U.A.W.* v. *Hooser Cordial Corp.*, 383 U. S. 696 (1966); *Holmberg* v. *Armbrecht*, 327 U. S. 392 (1946). This rule was recently

reaffirmed in *Ernst & Ernst* v. *Hochfelder*, 425 U. S. 185, 210, n.29 (1976).

The problem arises, however, when the forum state law contains two or more different but relevant limitation periods. This is not a matter of first impression for courts in the Sixth Circuit. Recently, the Sixth Circuit Court of Appeals determined this same question with respect to Ohio state law in *Nichels* v. *Koehler Management Corp.*, 541 F. 2d 611 (6th Cir. 1976). It held ". . . the Federal Courts must choose among the several state statutes of limitations and apply that one which best effectuates the federal policy at issue." 541 F. 2d at 613, *citing I.D.S. Progressive Fund, Inc.* v. *First of Michigan Corp.*, 533 F. 2d 340, 342 (6th Cir. 1976), *which quoted, Charney* v. *Thomas*, 372 F. 2d 97, 100 (6th Cir. 1967). The issue here is which state statute of limitations better implements the federal policies under Sections 10(b), 14(e), 20 and SEC Rule 10b-5.

The defendants argue that Kentucky Revised Statute §292.480(3) (Supp. 1976) [hereinafter "KRS"], the three-year statute of limitations for the Kentucky Blue Sky Law, is applicable and thus the plaintiffs' claims are barred. The plaintiffs, on the other hand, submit that KRS 413.120(12) (1964), the five-year statute of limitations for general fund is applicable; therefore, their claims are not barred.

As was noted earlier, the Sxith Circuit Court of Appeals has considered this issue on at least three previous occasions: *Nichels* (considering Ohio law), *IDS Progressive Fund*, and *Charney* (both considering Michigan law). In all three cases the Court found that the longer general statute of limitations for fraud applied rather than the statute of limitations applicable to the states' blue sky or securities law.

It would be an easy matter for this Court to hold that the Kentucky general fraud statute of limitations applies to the present action under the theory of stare decisis; however, because of two factors, a closer analysis is warranted. First, the Sixth Circuit's opinions seems to represent the minority view among the several circuits that have considered the issue. Second, this Court does not have the benefit of a higher court's determination of the appropriate Kentucky statute of limitations.

The Court agrees with defendants in that the majority of circuits have chosen to apply the applicable state blue sky statutory period of limitation. *See e.g., Berry Petroleum Co.* v. *Adams & Peck,* 518 F. 2d 402 (2d Cir. 1975); *Newman* v. *Prior,* 518 F. 2d 97 (4th Cir. 1975); *Hudak* v. *Economic Research Analysts, Inc.,* 499 F. 2d 996 (5th Cir. 1974); *cert. denied,* 419 U. S. 1122 (1975); *LaRosa Building Corp.* v. *Equitable Life Assurance Society,* 542 F. 2d 990 (7th Cir. 1976); *Vanderboom* v. *Sexton,* 422 F. 2d 1233 (8th Cir. 1970); and *Forrestal Village, Inc.* v. *Graham,* 551 F. 2d 411 (D.C. Cir. 1977).

The minority view is followed by three circuits. *Nickels* v. *Koehler Management Corporation, supra* (6th Cir.); *United California Bank* v. *Salik,* 481 F. 2d 1012 (9th Cir. 1973), *cert. denied,* 414 U. S. 1004 (1973); and *Clegg* v. *Conk,* 507 F. 2d 1351 (10th Cir. 1974), *cert. denied,* 422 U. S. 1007 (1975). The two contrasting views seem to follow either *Charney, supra,* in the Sixth Circuit or *Vanderboom, supra,* in the Eighth Circuit.

In *Charney,* the purchasers of common stock of the Clinton Engines Corporation brought suit against the operating officers and controlling stockholders of Clinton because of a fraudulent misrepresentation of the inventory at the time of the sale. The District Court of the Eastern District of Michigan granted defendants' motion to dismiss because the Michigan "Blue Sky Law," MSA §19.756, Comp.

Laws 1948, §451.116, granted the sole remedy for fraud in the sale of securities in that state and therefore the suit was barred by the two-year statute of limitations which applied to any claim under Section 10 of the Exchange Act. The Sixth Circuit Court of Appeals reversed and held that the applicable statute of limitations for a claim under Section 10 of the Exchange Act was the six-year general fraud statute of limitations. The Court found that the case of *Detwiler* v. *Olavin,* 138 N. W. 2d 336 (1965) had been decided by the Michigan Supreme Court subsequent to the dismissal by the district court. In *Detwiler* it was held that a defrauded purchaser had his choice of remedies under the common law or under the securities law; the common law action for fraud had not been abrogated by the statute.

> "Thus, the legislature may have meant to provide a potential plaintiff with a choice between the statutory action with its short limitation period and the more difficult to prove common law action with its longer limitation period as a compensation." 372 F. 2d at 99.

Beyond this, the reasoning of the Court is not as comprehensive as later cases; however, it is apparent that the Court reasoned that the plaintiff should have at least as much time to bring his suit under the federal claim as they would under the comparable state claim.

The Ninth Circuit Court of Appeals reached the same result in *United California Bank* v. *Salik, supra.* The Court held that the applicable state statute of limitations for Section 10(b) of the Exchange Act was California's three-year limitations period for fraud cases rather than the special limitations statute permitting suit for security fraud. The Court had found the fraud limitation applicable in several earlier cases. The Court stated:

> We do not believe federal policy is advanced by changing the law governing the timeliness of federal claims to correspond with each change in the substantive elements of a claim under the local securities law. Aggrieved persons have come to rely upon our prior holdings. Reasonable stability in laws pertaining to voluntary relationships between parties, and the right of access to the courts to question those relationships, is a worthwhile objective as well.

481 F. 2d at 1015, *quoting, Douglas* v. *Glen E. Hinton Investments, Inc.*, 440 F. 2d 912, 916 (9th Cir. 1971).

The second reason for its holding was that ". . . the broad remedial policies of the federal securities laws are best served by a longer, not a shorter, statute of limitation." 481 F. 2d at 1015.

The same issue was again before the Sixth Circuit and decided twice in 1976. The first case was *IDS Progressive Fund, Inc.* v. *First of Michigan Corp., supra.* The Circuit Court upheld the District Court for the Eastern District of Michigan in its holding that the six-year common law fraud statute of limitations applied to Section 10(b) of the Exchange Act and SEC Rule 10b-5. The plaintiffs alleged that they were induced to purchase the common stock of Great Markwestern Packing Co. by a false and misleading prospectus prepared by defendant First of Michigan.

The State of Michigan had adopted the Uniform Securities Act subsequent to the *Charney* case. Furthermore, the Fifth, Seventh and Eighth Circuits had since dealt with the issue and had found that the statute of limitations in the state Blue Sky Laws to be the limitation periods which best effectuates federal policy.

Although the defendant emphasized the virtual identity of Section 101 of the Uniform Act and Rule 10b-5, the

Court found Section 101 to be an exclusively criminal provision which did not give rise to civil liability. 533 F. 2d at 343. The Court determined that Section 410 of the Uniform Act gave rise to civil liability and that the "but" clause in Section 410(h) was designed to assure that no implied civil cause of action would be found in Section 101 as had developed in Rule 10b-5 actions. 533 F. 2d at 343, n.1.

After a cursory and somewhat inaccurate comparison of Section 410 and Rule 10b-5 (since we now have the benefit of *Ernst & Ernst* v. *Hochfelder, supra*) the Court gave two reasons for its holding. First, the Court was unwilling, absent good cause, to change their prior holdings, citing the *Douglas* case, *supra.* Second, agreeing with the Ninth Circuit in *United California Bank,* the Court stated ". . . the broad remedial policies of the federal securities laws are best served by a longer, not a shorter statute of limitations." 533 F. 2d at 344.

Probably the most complete and best reasoned analysis of this issue occurred in the Sixth Circuit Court of Appeals' opinion later in 1976 in *Nickels* v. *Koehler Management Corp., supra.* The plaintiffs in the two consolidated cases were stockholders or former stockholders in corporations which were acquired or merged. The plaintiffs were somewhat analogous to the present plaintiffs in that they gave up their shares much the same as would a seller. In *Nickels* it was held that the four-year general fraud statute of limitations of Ohio, rather than the two-year limitation of the Ohio Blue Sky Law, was the more appropriate limitation period to apply to federal securities fraud claims.

The defendants urged the Court to adopt the majority view under *Vanderboom* v. *Sexton, supra,* and hold that the Blue Sky Laws "bears the closest resemblance to the federal statute involved." 541 F. 2d at 615. They first contended that the two-year limitation of the Ohio Blue Sky law governed both statutory and common law claims for

securities fraud. The Court rejected this argument. The defendants' second argument was that the Rule 10b-5 cause of action more closely resembled the blue sky cause of action than the common law cause of action; therefore, the two-year limitation period applied. The following analysis was most revealing but not especially determinative on the basis of defendants' arguments.

The Court compared the Ohio Blue Sky Law, the common law action for fraud and the Rule 10b-5 cause of action in regard to: (1) to whom the remedy was available; (2) whether reliance was required; (3) whether scienter was a necessary element; and (4) the scope of the recovery. They found that both the Ohio common law of fraud and blue sky statute bear a marked resemblance to the Rule 10b-5 cause of action although neither was identical with it. Of importance is this statement:

> We conclude that the common law of fraud is *sufficiently similar* [emphasis added] to the case law developing under §10(b) and Rule 10b-5 that federal policy will be best served by the *continued* application of the four-year limitation period that we approved in *Connelly* v. *Balkwill, supra.*

541 F. 2d at 618. The Court also relied upon *IDS Progressive Fund, Inc., supra,* and further stated:

> . . . we should not change the limitation period applicable to 10b-5 actions without "good cause" because to do otherwise adds "unnecessary uncertainty to the prosecution of federal claims under Section 10b-5." Moreover, we observe that the broad remedial purposes of the federal securities acts are "best served by a longer, not a shorter statute of limitations." Applying these two principles to the case before us we hold

> that the four year fraud statute of limitations, upon which the parties may have relied, is applicable.

[citations omitted] 541 F. 2d at 618.

Therefore, the precedent set by the Sixth Circuit Court of Appeals is not exact similarity with the state statute but rather *sufficient similarity* for the continued application of the common law fraud statute of limitations.

The *Vanderboom* line of cases, which defendants claim to be the better reasoned as well as the majority view, could be persuasive authority for this Court to consider. Consequently, these cases deserve close analysis.

The Eighth Circuit Court of Appeals decided *Vanderboom* in 1970. It involved a suit based on Arkansas common law fraud as well as federal securities violations relating to untrue statements or misleading omissions connected with the purchase of securities. Arkansas had adopted Section 410(e) of the Uniform Securities Act which contained a two-year limitation period from the relevant contract of sale. The Court of Appeals agreed with the District Court in that the two-year limitation was proper because it dealt "expressly with the sale of securities." 422 F. 2d at 1237. But their analysis went further and they looked at each of the local statutes to determine which bears the closest resemblance to the federal statute involved, specifically Rule 10b-5.

They found that although Section 101 of the Uniform Act as adopted by the State of Arkansas was a codification of Rule 10b-5, it was not appropriate since it created no private remedy. They found that Arkansas' equivalent to Section 410 of the Uniform Act which was modeled after and parallels Section 12(2) of the Securities Act of 1933, 15 U.S.C.A. §77e(2), provided a civil remedy and was appropriate for comparison with Rule 10b-5. They found that

Rule 10b-5 and Section 410 were not identical; however, neither required scienter which made them more analogous than the common-law fraud cause of action. Of extreme importance to the outcome of the case is the following quotation:

> In the case of Trussell v. United Underwriters Ltd., 228 F. Supp. 757 (D. Col. 1964) the Court, following a controlling 10th Circuit opinion, Rice v. United States, 149 F. 2d 601 (10th Cir. 1945), construed Rule 10b-5 to require scienter and to be basically analogous to common law fraud. *Under such a construction it was perhaps correct to use the local statute of limitations which specifically applied to common law fraud, rather than the statute of limitations pertaining to the local blue-sky law* in which the private remedy was comparable to §12(2) of the Securities Act of 1933 which provides recovery for negligent as well as knowing and intentional misrepresentations. Similarly, in Charney v. Thomas, *supra,* the Court held that the local blue-sky private remedy (also taken from §410 of the Uniform Securities Act and based upon §12(2) of the Securities Act of 1933) was comparable to §12(2) and not to Rule 10b-5 and thus applied the state statute of limitations applicable to fraud. *However, the present rule in the 8th Circuit is that Rule 10b-5 applies to negligent as well as intentional misrepresentations.* [citations omitted, emphasis added].

422 F. 2d at 1238.

With the enlightenment of *Ernst & Ernst* v. *Hochfelder, supra,* which held that Rule 10b-5 actions required scienter, it is apparent that the Eighth Circuit Court of Appeals would have found differently.

This reasoning is also quite pronounced in the Fifth Circuit case of *Hudak* v. *Economic Research Analyst, Inc., supra:*

> We concur in the reasoned judgments of the Seventh and Eighth Circuits which, when faced with the present choice between a forum state's fraud and blue sky limitations periods for use in federal securities litigation, *found the similarity between the blue sky and 10b-5 scienter requirements crucial to their determination.* Parrent v. Midwest Rug Mills, Inc., 7 Cir. 1972, 455 F. 2d 123; Vanderboom v. Sexton, 8 Cir. 1970, 422 F. 2d 1233. Given the similarity of §517.301(1) and Rule 10b-5, in both language and interpretation, and the congruence between the specific remedy sought here—return of the purchase money—and the remedy of recission for which Florida securities law provides a two-year statute, we hold that the district court erred in applying the three-year fraud period. [emphasis added].

499 F. 2d at 1000.

Plaintiff urges the Court that cases subsequent to *Ernst & Ernst* v. *Hochfelder, supra,* have adopted the majority view notwithstanding the incorrect interpretation of the scienter requirement of *Vanderboom.* For this proposition, defendant relies upon *Forrestal Village, Inc.* v. *Graham,* 551 F. 2d 411 (D.C. Vir. 1977); *McNeal* v. *Payne, Webber, Jackson & Curtis, Inc.,* 429 F. Supp. 359 (N.D. Ga. 1977); and *Bailey* v. *Piper, Jaffray & Hopwood, Inc.,* 414 F. Supp. 475 (D. Minn. 1976).

In *Forrestal Village, supra,* the District of Columbia Circuit Court of Appeals recognized that "some element of scienter" is required under Section 10(b) of the Exchange Act whereas the D.C. Act requires no more than negligence but concluded:

> Yet this possible difference between the federal statute and the local statute is easily outweighed by their similarities in both purpose and substance.

551 F. 2d at 414. The main similarity found between Section 10(b) and the D.C. Act was that they both "deal expressly with the sale of securities." *Id.*

The District Court for the Northern District of Georgia considered the plaintiffs' argument about the scienter requirement in *McNeal* v. *Paine, Webber, Jackson and Curtis, Inc., supra,* to be unpersuasive because the Georgia statute still bears the closest resemblance to Rule 10b-5 and shares a commonality of purpose with that rule. Without further analysis the Court stated: "These factors clearly outweigh any possible difference in the scienter requirements of the two provisions." 429 F. Supp. at 363.

In *Bailey* v. *Piper, Jaffray & Hopwood, Inc.* the District Court of Minnesota entered into an extensive discussion of the *Hochfelder* impact on the holdings of *Vanderboom* and the cases following it and concluded:

> "The basic standard of *Vanderboom* for choosing the appropriate limitations provision—that which best " 'effectuates the federal policy at issue' "—still stands after *Hochfelder.* Also remaining is the exhortation of *Vanderboom* to ". . . look to the local statute which bears the closest resemblance to the federal statute involved." (Citation omitted).

414 F. Supp. at 479. The Court further reasoned that:

> Although the Minnesota Blue Sky Law did not have any precise counterpart to Rule 10b-5 it is the statutory scheme which bears the closest resemblance to the federal securities law. The evidenced intent of the legislature to prevent fraud in dealings of securities

> through a statutory scheme specifically concerned with securities is sufficient to accord it a "commonality of purpose" with the federal securities laws.

Id. at 482.

This Court agrees that this may well represent the trend after *Hochfelder;* however, whether it is determinative in the present action may be a different matter. The reasoning certainly does not coincide with the Sixth Circuit's view in *Charney* that the longer limitation of the more difficult to prove common law cause of action is compatible with the easier to prove statutory cause of action with the shorter period of limitation. 372 F. 2d at 99.

Turning now to Kentucky law, the Court must analyze each statutory and common law remedy to determine which one "best effectuates the federal policy at issue" and apply the appropriate limitation period to the federal claims here present. There are two Kentucky statutory and one common law causes of action to compare.

KRS §292.320 (Supp. 1976) in pertinent part reads:

> 292.320. *Fraudulent and other prohibited practices*
>
> (1) It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:
>
> (a) To employ any device, scheme, or artifice to defraud;
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

KRS §292.480(1) (Supp. 1976) in pertinent part reads:

> 292.480 *Civil liabilities*
>
> (1) Any person, who offers or sells a security in violation of this chapter or of any rules and regulations promulgated hereunder or offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made not misleading (the buyer not knowing of the untruth or omission) and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per annum from the date of payment costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less (a) the value of the security when the buyer is disposed of it and (b) interest at six percent per annum from the date of disposition.

The common law cause of action is illustrated by the elements pointed out in *Keck* v. *Wackers*, 413 F. Supp. 1377, 1383 (E.D. Ky. 1976):

> The standard for actionable fraud is that the "misrepresentation must be made with knowledge of its falsity or under circumstances that do not justify a belief in its truth." Walser v. Glenn, 400 S. W. 2d 223,

224 (Ky. 1966). Similarly, it has been held that the essential elements of actionable fraud are:

> (1) that [the seller] made a material representation;
>
> (2) that it was false;
>
> (3) that when he made it he knew it was false, or made it recklessly, without any knowledge of its truth and as a positive assertion;
>
> (4) that he made it with intention of inducing [the buyer] to act, or that it should be acted upon by [the buyer];
>
> (5) that [the buyer] acted in reliance upon it, and
>
> (6) that [the buyer] thereby suffered injury.

Sanford Construction Co. v. S & H Contractors, Inc., supra, 443 S. W. 2d at 231, citing Crescent Grocery Co. v. Vick, 194 Ky. 727, 240 S. W. 388 (1922).

The applicable limitations period for the two statutory causes of action is three years, KRS §292.480(3), while the applicable limitation period for the common law cause of action is five years, KRS §413.120(12) (1964).

Following the cases cited above, the first area of comparison is concerned with the availability of remedies to certain parties. It is apparent from its face that KRS §292.480(1) provides a remedy only to a defrauded *purchaser* while Section 10(b) and 14(e) of the Exchange Act and Kentucky common law afford a remedy to the defrauded *seller* as well as the purchaser. The plaintiffs in the instant case are defrauded sellers and KRS §292.480(1) does not provide them with a civil remedy.

Defendants have argued that KRS §292.320(1) is the appropriate statute since it would provide relief to a defrauded seller. On its face, KRS §292.320(1) only applies to criminal sanction and does not expressly grant a civil

remedy; however, it is defendants' position that there is an *implied* civil remedy much like what has developed under Rule 10b-5. The defendants cite as authority for this implied civil cause of action, *Shermer* v. *Baker,* 472 P. 2d 589 (1970) where the Washington State Court of Appeals held such an implied cause of action could be maintained under a statute much like KRS §292.320(1) patterned after Section 101 of the Uniform Act.

Defendants further maintain that the Kentucky Court of Appeals (now Supreme Court of Kentucky) in *City of Owensboro* v. *First U. S. Corporation,* 534 S. W. 2d 789 (Ky. 1975) implied a civil cause of action under KRS §292.320(1) by citing it while applying the resemblance test to Section 17(a) of the Exchange Act rather than making the comparison between Section 17(a) and KRS §292.480(1). Defendants further contend that the Kentucky legislature's election not to adopt Section 410(h) of the Uniform Act in KRS §292.480 represents a clear indication that ". . . it must have at least intended that KRS §292.320(1) (the comparable provision to Section 101 of the Uniform Act) could be the basis for an implied cause of action." This position apparently stems from the *IDS Progressive Fund, Inc.* opinion where the Sixth Circuit Court of Appeals considered the official comments to Section 410(h) and determined that that Section expressly precluded such an implied cause of action in Section 101. Section 410(h) provides for the preservation of rights and remedies existing at law or equity in addition to any created by the civil liability section of the law.

Unlike the Sixth Circuit Court of Appeals in *Charney, supra* at 98, which relied upon the Supreme Court of Michigan decision of *Detwiler* v. *Glavin, supra,* which expressly held that the defrauded purchaser had his choice of remedies, the Kentucky Court of Appeals in *City of Owensboro, supra,* has declared that KRS §292.320(1) represents

the exclusive remedy for a defrauded seller of securities. The Court said:

> The lot of the seller is made more onerous by the Blue Sky Statute in misrepresentation cases when it allows recovery where the seller "does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission, . . ." KRS 292.480(1) (emphasis supplied). Some of the inhibiting strictures of the law of misrepresentations are relaxed and the price exacted is the shortened limitations period. It seems to us that this is a matter of legislative policy. If the legislature would choose to make the blue sky remedy for sale by misrepresentation cumulative, it is free to do so, but in our view it has not done so yet.

534 S. W. 2d at 791.

Recently, the United States District Court for the Western District of Kentucky at Louisville in *Payne* v. *Fidelity Homes of America, Inc.*, No. C 74-345-L(B) (W.D. Ky. Sept. 22, 1977) held that the three-year statute of limitations in KRS §292.320 time-barred a defrauded purchaser of securities. The Court principally relied upon the holding of *City of Owensboro, supra,* to distinguish its Kentucky-forum case with *Charney, supra,* which arose in the forum of Michigan.

We cannot disagree with the wisdom of that decision; however, a distinction can and should be made between defrauded buyers and sellers. The instant case involves a defrauded seller whereas all authority available considers a defrauded buyer. A reading of the Draftsmen's Commentary to Section 101 of the Uniform Act (which is similar to KRS §292.320) makes this distinction apparent:

"At the same time, there is no clear need to create any civil liability against buyers as distinct from sellers. Although the lower federal courts have uniformly implied a civil cause of action against fraudulent buyers under the SEC rule, the federal courts when applying federal law do not have at their disposal all of the common-law and equitable remedies of deceit and rescission which are available to the state courts without benefit of statute. *In the area of civil liability, moreover, it seems not only unnecessary but unwise to disturb the general jurisprudence which has been developing with reference, for example, to the obligation of corporate insiders to make affirmative disclosure when purchasing from existing stockholder.* On the other hand, the general law is not adequate to deal with flagrant cases of fraud by buyers on a *criminal* level. and there can, of course, be no public action for an injunction against such practices without specific statutory authority." [Emphasis added].

Therefore, notwithstanding the omission of Section 410(h) in the adoption of the Kentucky Blue Sky Laws KRS §292.310 *et seq.*, we find that the *implied* remedy, if such exists, only applies to defrauded purchasers and not to defrauded sellers.

The second phase of our analysis concerns the standard of proof with respect to the wrongdoer's knowledge of the claimed untruth or omission (scienter). Because of the *Hochfelder* decision, it is now clear and standard among the circuits that something more than mere negligence is necessary to maintain an action under Rule 10b-5 and by analogy this would apply with equal force to Sections 14(e) and 20 of the Exchange Act. In short, the federal claims require "scienter." KRS §292.480, in comparison, only applies the standard of negligence. It provides that one

". . . who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from him. . . ." The common law fraud action, in contrast, requires a specific showing of knowing intent or scienter on the part of the defrauding party. *See Keck* v. *Wackers, supra.*

The third factor to consider in our comparison is the element of reliance on the part of the defrauded party. A plaintiff need not allege or prove reliance when pursuing his claim under KRS §292.480(1). On the other hand, where an actual misrepresentation is involved, reliance must be alleged and proved under a Rule 10b-5 cause of action, *Marx* v. *Computer Science Corp.*, 507 F. 2d 485, 491 (9th Cir. 1974) even though the requirement is relaxed in the case of an omission to state a material fact. *Affiliated Ute Citizens* v. *United States,* 406 U. S. 128, 154 (1972). The common law cause of action requires that the defrauded person act in reliance of the material representation or omission. *Keck* v. *Wackers, supra.*

The final comparison to be made is concerned with the relief available. Under Section 10(b), a defrauded party may get rescission of the transaction or damages resulting from the fraud. *Affiliated Ute Citizens* v. *United States, supra,* at 155; *Janigan* v. *Taylor,* 344 F. 2d 781 (1st Cir. 1965), *cert. denied,* 382 U. S. 879 (1965); *Myzel* v. *Fields,* 386 F. 2d 718, 748 (8th Cir. 1967), *cert. denied,* 390 U. S. 951 (1968). The common law entitled the defrauded party to compensation for every wrong which was the result of the fraud. *Joe-Lee, Inc.* v. *Francke,* 531 S. W. 2d 711 (Ky. 1976). Conversely, the remedy available under KRS §292.480(1) simply is not appropriate since it affords a remedy only to a purchaser and not a seller of securities. One who retains possession of the securities may only re-

cover the consideration paid for the securities in addition to court costs and reasonable attorneys' fees.

In summary, we find that the Kentucky common law cause of action is sufficiently similar to the federal claims so as to make KRS §413.120(12), the five-year statute of limitations for common law fraud actions, the most appropriate and the one which best effectuates the federal policy at issue.

Shareholders' Derivative Action Question

Paragraphs 39(b), 40 and 41(a) of plaintiffs' amended complaint request in the alternative to damages, that the Cybernetics stock and options be restored to the plaintiffs and that the defendants account for and restore to Cybernetics all sums wrongfully diverted or withheld from Cybernetics. Just as the remedy of damage would restore to the plaintiffs the reasonable value of the stock they were fraudulently induced to sell, if the alternative remedy of rescission is allowed, an accounting and restitution would be appropriate to restore them to the prior value of their holdings.

Defendants urge the Court that plaintiffs are not presently stockholders and cannot seek this relief. Although Rule 23.1 of the Federal Rules of Civil Procedure only requires that the plaintiffs be shareholders at the time of the transaction of which they complain, defendants cite numerous authorities that imply a condition of present stockholder status and thus relief should not be granted. The Court does not find these authorities controlling because the plaintiffs will in fact be present stockholders if the sale is rescinded.

Without deciding whether damages or rescission is the most appropriate remedy and without deciding the exact measure of damages, we find that judicial economy would

not be furthered by deciding rescission of the sale in one suit and then requiring the then plaintiff/stockholders to bring an additional suit for an accounting and restitution.

The Court finds that the plaintiffs are not barred from this relief simply because they are not presently stockholders of Cybernetics; nevertheless, just because the relief is sought in the alternative in the procedural sense of Rule 8(a) of the Federal Rules of Civil Procedure does not immunize the plaintiffs from compliance with the technical requirements of Rule 23.1. Therefore, paragraphs 39(b), 40 and 41(a) of the amended complaint and paragraphs 40(b), 41 and 42(a) of the original complaint shall be dismissed without prejudice. The Court, however, *sua sponte*, grants the plaintiffs leave to amend their complaint so as to conform to the technical requirements of Rule 23.1.

Pendent State Claims Question

Because the Court has not dismissed the federal claims upon which subject matter jurisdiction has been conferred, the question of dismissal of the state pendent claims is moot.

Conclusion

For the above-stated reasons the Court HEREBY ORDERS that the defendants' motion for summary judgment insofar as it relates to the issue of the applicable statute of limitation be and is hereby OVERRULED.

IT IS FURTHER ORDERED that paragraphs 39(b), 40 and 41(a) of plaintiffs' amended complaint and paragraphs 40(b), 41 and 42(a) of plaintiffs' original complaint be DISMISSED without prejudice; however, plaintiffs shall have leave of Court to amend their complaint so as to conform to the technical requirements of Rule 23.1 of the Federal Rules of Civil Procedure.

IT IS FURTHER ORDERED that defendants' motion for summary judgment relating to the pendent state claims be OVERRULED.

James F. Gordon
Senior U. S. District Judge

Date 11-1-77

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF KENTUCKY

Civil No. 77-0066-L(G)

JOSEPH A. CAROTHERS, ET AL.

v.

W. THOMAS RICE, ET AL.

MEMORANDUM OPINION AND ORDER—Filed March 3, 1978

John L. Carroll, Esquire, Evansville, Indiana, Lawrence L. Pedley, Esquire, Louisville, Kentucky, William T. Warner, Esquire, Louisville, Kentucky, and Robert P. Ross, Esquire, Louisville, Kentucky, Counsel for the Plaintiffs.

Joseph E. Stopher, Esquire, Louisville, Kentucky, Edward H. Stopher, Esquire, Louisville, Kentucky, Robert C. Moore, Esquire, Louisville, Kentucky, Oscar N. Persons, Esquire, Atlanta, Georgia, F. Dean Copeland, Esquire, Atlanta, Georgia, Franklin R. Nix, Esquire, Atlanta, Georgia, and Jeffery P. Adams, Atlanta, Georgia, Counsel for Defendants.

Gordon, Senior United States District Judge.

This action is before the Court on defendants' motion to reconsider this Court's order of November 7, 1977, wherein it denied defendants' motion to dismiss. Oral arguments were heard January 9, 1978, in Louisville, Kentucky.

The central issue of the original motion and the motion for reconsideration concerns the statute of limitations to

be applied to plaintiffs' claims under Sections 10(b), 14(e) and 20 of the Securities Exchange Act of 1934, as amended, 15 U.S.C.A. §78a, *et seq.*, and Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. §240.10b-5. It is settled that these sections have no explicit federal statute of limitations, and federal courts should borrow the limitation period proscribed by the forum state law which best effectuates the federal policy at issue. Here is where the problem arises. Defendants argue that the claims are barred by the three-year statute of limitations applicable to Kentucky's blue sky laws, because they most closely resemble the federal claims. The plaintiffs, on the other hand, argue their claims are still timely under the five-year statute of limitations for common-law fraud in Kentucky.

In the Court's November order, the defendants' motion to dismiss (treated as motion for summary judgment) was overruled because the longer statute of limitation for common-law fraud was considered to be more reflective of the federal policy underlying the present federal claims. Little was added during the oral hearing on reconsideration of that order to influence a change in this Court's position; nevertheless, the Court realizes that its position represents a very "close call," and there is substantial ground for difference of opinion. This is especially so in light of the decision of my colleague Judge Allen in *Payne* v. *Fidelity Homes of America, Inc.*, No. C-74-345-L(B) (W.D. Ky. September 22, 1977), where he held that the blue sky, three-year statute of limitations barred a defrauded purchaser of securities. This case was distinguished by us because the present plaintiffs are defrauded sellers of securities. The Kentucky Court of Appeals (now Supreme Court) also held in *City of Owensboro* v. *First U. S. Corp.*, 534 S. W. 2d 789 (Ky. 1975) that the blue sky statute of limitations would apply to the federal claim of a defrauded purchaser.

Therefore, this Court's decision, even though considered well reasoned and the better approach, flies in the face of two other Kentucky decisions. The majority of Circuit Courts in other Circuits have also taken the contrary view. The Sixth Circuit Court of Appeals' prior treatment of this question in *Nichols* v. *Koehler Management Corp.*, 541 F. 2d 611, (6th Cir. 1976), *I.D.S. Progressive Fund, Inc.* v. *First of Michigan Corp.* 533 F. 2d 340 (6th Cir. 1976), and *Charney* v. *Thomas,* 372 F. 2d 340 (6th Cir. 1967), because of the differences in state law, has been of little benefit to this Court in deciding the issue relative to Kentucky law.

The second matter taken under reconsideration involved paragraph 39 (a) of the plaintiffs' amended complaint. Through an oversight, he Court did not mention this paragraph in its November order. The Court agrees with defendants in that this paragraph is derivative in nature and should be presented in accordance with Rule 23.1 of the Federal Rules of Civil Procedure. Therefore, just as paragraphs 39(b), 40 and 41(a) of the amended complaint, paragraph 39(a) should be dismissed without prejudice until such time as the plaintiffs amend their complaint so as to conform to the technical requirements of Rule 23.1. Therefore,

IT IS ORDERED that defendants' motion for reconsideration of this Court's November order be, and is hereby, OVERRULED.

However, pursuant to 28 U.S.C. §1292(b), this Judge is of the opinion that this order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation and prays that the Court of Appeals will accept said interlocutory appeal on our "close call" so that defendants not improperly be subjected to extensive

preparation for the defense hereof and the large attorney fees involved in such in the event we should be held in error.

IT IS FURTHER ORDERED that paragraph 39(a) of the amended complaint and its corresponding paragraph in the original complaint be DISMISSED without prejudice.

(s) James F. Gordon
Senior U. S. District Judge

Date March 1, 1978

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

No. 78-3366

JOSEPH A. CAROTHERS, PAUL L. SCHMETZER, JOSEPH A. MUNGOVAN and DAVID E. FLANIGAN, Individually and as Representative of a Class of Certain Shareholders and Stock Option Holders of CYBERNETICS & SYSTEMS, INC., a Delaware Corporation, - - *Plaintiffs-Appellees;*

v.

W. THOMAS RICE,
PRIME F. OSBORN,
CYBERNETICS & SYSTEMS, INC.;
L & N INVESTMENT CORPORATION;
LOUISVILLE AND NASHVILLE RAILROAD COMPANY;
SEABOARD COAST LINE RAILROAD COMPANY; and
SEABOARD COAST LINE INDUSTRIES, INC.
Defendants-Appellants.

Appeal from the United States District Court
for the Western District of Kentucky
at Louisville

Argued March 31, 1980 Decided September 15, 1980

OPINION

Before BROWN, KENNEDY and JONES, Circuit Judges.

Franklin R. Nix, Oscar N. Persons, Alston, Miller & Gaines, F. Dean Copeland, Jeffrey P. Adams, Altanta, Ga., Joseph E. Stopher and Edward H. Stopher, Boehl, Stopher, Graves & Deindoerfer, Louisville, Ky., for defendants-appellants.

John L. Carroll, Johnson, Carroll & Griffith, Professional Corp., Evansville, Ind., Lawrence L. Pedley, William T. Warner, Robert P. Ross, Wood, Goldberg, Pedley & Stansbury, Louisville, Ky., for plaintiffs-appellees.

Before: BROWN, KENNEDY and JONES, Circuit Judges.

CORNELIA G. KENNEDY, Circuit Judge: We permitted an interlocutory appeal in this case to decide what statute of limitations should be applied to a claim under §10(b) of the Securities and Exchange Act of 1934 (1934 Act) (15 U.S.C. §78j(b)) and rule 10b-5 of the Securities and Exchange Commission filed in Kentucky. Appellees filed their complaint in the United States District Court for the Western District of Kentucky alleging that they were fraudulently induced to sell their stock in Cybernetics Systems, Inc. by appellants' misrepresentations and omissions in a tender offer in violation of §10(b) and rule 10b-5 and the laws of Kentucky, Delaware, and Virginia. They prayed for damages or, alternatively, rescission. Appellants moved to dismiss on the ground that the action was time-barred by the three year statute of limitations in Kentucky's Blue Sky Law, Ky. Rev. Stat. Ann. §292.480(3). The District Court denied the motion, holding that the action was timely under Kentucky's five year statute of limitations for claims based on fraud, Ky. Rev. Stat. Ann. §413.120(12). He certified the choice of the five year statute under 28 U.S.C. §1292(b) as a controlling question of law as to which there is substantial ground for difference of opinion.

There is no federal statute of limitations for §10(b) and rule 10b-5 actions. The private cause of action against one who violates their terms was not expressly granted. Rather, after numerous district courts and court of appeals found an implied private cause of action, the United States Supreme Court confirmed that such a cause of action did exist. In the absence of a federal statute of limitations, this Court

must look to the statutes of the forum state, Kentucky, and apply that which best effectuates the purposes of the federal securities laws. *See Ernst & Ernest* v. *Hochfelder,* 425 U. S. 185, 210 n.29 (1976); *Gaudin* v. *KDI Corp.,* 576 F. 2d 708, 711 (6th Cir. 1978); *Charney* v. *Thomas,* 372 F. 3d 97, 100 (6th Cir. 1967).

Appellants argue the blue sky law should apply as defrauded sellers have an implied remedy therein; the criminal liability section, Ky. Rev. Stat. Ann. §292.320(1), is virtually identical with rule 10b-5; the blue sky law has the same purpose as the federal securities laws; Kentucky has held that its blue sky law contains the sole appropriate limitation period for a federal claim by a purchaser of securities, induced by a misrepresentation, against the seller; and shorter, not longer, statutes of limitations better effectuate the purpose behind the federal securities laws. Appellees argue that the common law fraud action is closed to a 10b-5 claim than a claim under Kentucky's Blue Sky Law as defrauded sellers do not have a remedy under the blue sky law; both 10b-5 and fraud actions require scienter while the blue sky law claim does not; both 10b-5 and fraud actions require the plaintiff to have relied upon the misrepresentation while the blue sky law does not; both 10b-5 and fraud actions allow rescission or damages but the blue sky law only allows damages if the plaintiff no longer possesses the securities; and longer, not shorter, statutes of limitations better effectuate the purposes behind the federal securities laws.

I.

Section 413.120(12) provides that an "action for relief or damages on the ground of fraud or mistake" shall be commenced within five years after the cause of action accrued.

Section 292.320(1) provides:

(1) It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

(a) to Employ any device, scheme, or artifice to defraud;

(b) To make any untrue statement of fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

An express civil remedy is provided in §292.480(1):

(1) Any person, who offers or sells a security in violation of this chapter or of any rules and regulations promulgated hereunder or offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made not misleading (the buyer not knowing of the untruth or omission) and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent per annum from the date of payment costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would

> be recoverable upon a tender less (a) the value of the security when the buyer is disposed of it and (b) interest at six percent per annum from the date of disposition.

This remedy is limited by a three year statute of limitations provided in §292.480(3).

Kentucky's Blue Sky Law only expressly provides a civil remedy for defrauded purchasers; it provides a civil remedy for defrauded sellers like the appellees only if such a remedy can be implied. If no remedy can be implied, it would be improper to apply the statute of limitations from the blue sky law.

> Since the standard for determining the applicable statute of limitations is to select the statute that best effectuates the federal policy involved, it is appropriate to look to the local statute which bears the closest resemblance to the federal statute involved.

Vanderboom v. *Sexton*, 422 F. 2d 1233, 1237-38 (8th Cir.), *cert. denied*, 400 U. S. 852 (1970). If a plaintiff could bring his federal securities claim under state common law, but could not bring any such claim under state blue sky law, the state blue sky law could hardly be said to bear the closest resemblance to the federal statute.

Kentucky's Blue Sky Law is largely drawn from the Uniform Securities Act (U.S.A.). Appellants argue a cause of action for defrauded sellers can be implied both from the language and from the language not adopted from that Act.

Section 292.320(1) is almost an exact copy of U.S.A. §101, which provides:

> It is unlawful for any person, in connection with the offer, sale, or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

The comments to §101 explain that §101 is taken substantially from rule 10b-5, which was modeled after §17(a) of the Securities Act of 1933 (1933 Act).[1] Implied remedies under rule 10b-5 have been extended only to defrauded purchasers and defrauded sellers. *See Blue Chip Stamps* v. *Manor Drug Stores,* 421 U. S. 723 (1975); *Gaudin* v. *KDI Corp. supra,* 576 F. 2d at 711.

U.S.A. provides expressly for civil liability for defrauded purchasers in §410, which is similar to §292.480(1) except that the Kentucky legislature did not adopt §410(h) of U.S.A.. It is section 410(h) which provides that the

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[1]Rule 10b-5 (17 C.F.R. §240.10b-5) read as folows:

§240.10b-5 Employment of manipulative and deceptive devices. It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifive to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchaser or sale of any security.

statutory remedies shall be in addition to the remedies provided at common law and that no remedies shall be implied under the statute except as are expressly provided for in §410.[2] The comments to §410 clearly proscribe any implication of a remedy for defrauded sellers even though private causes of action have been implied under rule 10b-5 for defrauded sellers as well as for defrauded purchasers. U.S.A., in §§414(a) and 414(b), applies §410 to any person who sells or offers to sell, but does not apply §410 to any person who buys or offers to buy.

The Kentucky legislature did not enact §410(h) of U.S.A., nor did it enact §§414(a) and 414(b). The failure to enact these section indicates that the Kentucky legislature, unlike the drafters of U.S.A., did not intend to preclude implied remedies under the Kentucky Blue Sky Law similar to implied remedies under rule 10b-5. *Compare LaRosa Building Corp.* v. *Equitable Life Assurance Society of United States,* 542 F. 2d 990, 993 (7th Cir. 1976) (court concluded defrauded sellers had a remedy under Illinois Blue Sky Law as legislature originally had enacted subsection (h) precluding implied remedies but then repealed it).

Further, Kentucky intended its blue sky law to be coordinated with federal securities acts. Section 292.530 provides that the blue sky law "shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation and administration of this chapter with the related federal regulation." By itself this section would not neces-

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[2]Section 410(h) provides:

(h) the rights and remedies provided by this act are in addition to any other rights or remedies that may exist at law or in equity, but this act does not create any cause of action not specified in this section. . . .

sarily imply a remedy for defrauded sellers merely because federal law implies one as U.S.A. also contains such language and U.S.A. expressly prohibits the implication of an implied remedy for defrauded sellers.[3] However, combined with the failure to enact §410(h) of U.S.A., this section is persuasive evidence that the Kentucky legislature intended to allow implied remedies under its blue sky law to match those under rule 10b-5.

Kentucky case law, while not specifically addressing this point, is not adverse to implied remedies. Before Kentucky passed its present blue sky law based upon U.S.A., two cases came bofer Kentucky's highest court in which plaintiffs had argued the blue sky law then existing applied only where the seller of a security had failed to comply with the requirements of the Act and did not apply to complaints in which plaintiffs alleged they were induced to purchase securities by fraud and misrepresentation. Those plaintiffs argued that the statute of limitations provided in the blue sky law did not apply to pre-existing common law remedies for claims based on fraud but only applied to the new remedies created in the Act. The Kentucky court disagreed. It held that since the blue sky law also gave a remedy to defrauded purchasers, the statute of limitations in the blue sky law barred plaintiffs' claims. *See First State Bank of Pineville* v. *Slusher,* 267 Ky. 190, 101 S. W. 2d 661 (1937); *Thomas* v. *Fidelity & Casualty Co. of N.Y.,* 258 Ky. 360, 80 S. W. 2d 8 (1935). In *Slusher,* the Kentucky court also rejected the argument that the blue sky statute of limitations for damages did not apply to a suit for rescission in equity.

The Kentucky Supreme Court considered its current blue sky law in *City of Owensboro* v. *First U. S. Corp.,* 534

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[3]The fact that the drafters of the U.S.A. felt it necessary to expressly prohibit an implied cause of action is a recognition of the broad acceptance of the implied cause of action.

S. W. 2d 789 (Ky. 1975). A defrauded purchaser's claim under Kentucky law was dismissed as time-barred under §292.480(3). The court said that the Kentucky Blue Sky Law had been judicially construed to afford a remedy to a purchaser induced by misrepresentation to buy securities and that the proper statute of limitations was the one in the blue sky law. The revisions in 1960 and 1972 were not intended to change the result in *Slusher*. Indeed, the new law now expressly gave a civil remedy to a defrauded purchaser in §292.480(1). The court held that the blue sky law was meant to be the exclusive remedy; some of the inhibiting strictures of the law of misrepresentation were relaxed and the price enacted was the shortened limitations period. 534 S. W. 2d at 791.

Appellees seek to distinguish defrauded sellers from defrauded buyers. True, the language of §292.480(1) only expressly applied to defrauded purchasers. The drafters of U.S.A. explicitly recognized and warned against the likelihood of implied remedies similar to those implied under rule 10b-5 unless §410(h) was enacted to prevent implied remedies. The Kentucky legislature could easily have enacted §410(h) of U.S.A. to avoid implied remedies, but it did not do so. Appellees argue that defrauded sellers would have less opportunity to discover the fraud after the sale than defrauded purchasers as the sellers would no longer be connected with the corporation and would not receive any information from the corporation. This argument assumes that the owner of the shares would be likely to receive information from the corporation that would indicate fraud or misrepresentations, which is doubtful. Assuming that the share owner would be likely to receive helpful information, the defrauded seller would have been receiving information before he sold and would probably be in as good a position to detect fraud at the time of sale as the buyer would be after the sale. To the extent the

misrepresentations becomes evident through independent sources of information, neither buyer nor seller is in a better position to detect fraud. The purpose of the blue sky law "is to protect the public from fraud, deceit, and imposition in the sale of securities". *Thomas, supra,* 258 Ky. at 364. A person does not by merely buying a share of stock become more sophisticated, informed, less in need of protection, or more likely to discover fraud when he turns around to sell that share of stock. We hold that Kentucky would imply a remedy for defrauded sellers under §292.320(1) which prohibits any misrepresentation or omission of a material fact in connection with the sale or purchase of securities.[4]

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[4]Our colleague in dissent does not agree that Kentucky would imply a remedy for defrauded sellers under §292.320(1), relying in part upon *Cort* v. *Ash,* 422 U. S. 66 (1975), and progeny. However, we feel that reliance is misplaced. *Cort* and progeny dealt with an issue not present in the present case—that is, whether or not a federal cause of action may be implied from a federal statute. As the federal government is theoretically one of limited powers rather than one with general police powers, a court implying a federal right must be certain that a federal remedy was intended by the legislature rather than leaving the plaintiff to his common law and statutory remedies available in the state courts. Here, this Court need not decide whether or not a federal remedy should be implied—the Supreme Court has already recognized that there is an implied remedy for defrauded sellers under §10(b) of the 1934 Act. *See Ernst & Ernst* v. *Hochfelder,* 425 U. S. 185, 196 (1976); *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U. S. 723 (1975). Rather, the issue before this Court is whether or not Kentucky would imply a state cause of action under its state statute which is similar to the federal cause of action. The first and fourth factor to which *Cort* points—whether or not the statute creates a federal right in favor of the plaintiff and whether or not the cause of action is one traditionally relegated to state law (see note 1 of Judge Jones' dissent)—clearly are not applicable. The

(Footnote continued on next page)

Appellees argue that even if a remedy for defrauded sellers may be implied under §292.320(1), the three year statute of limitations in §292.480(3) would not apply as §292.480(3) applies only to civil remedies created by "this section", that is, §292.480. They argue an implied remedy under §292.320(1) is not a remedy created by §292.480. However, Kentucky does not limit the application of the statute of limitations in §292.480(3) to civil actions created by §292.480(1). In *Owensboro, supra*, the Kentucky Supreme Court applied §292.480(3) to a federal securities claim under §17(a) of the 1933 Act which it held to be similar to §292.320. It found that the blue sky limitation was "the most appropriate state statute applicable" to the claim. It would be anomalous to have one statute of limitations for sellers and another for purchasers. Thus, we conclude that the defrauded sellers' implied remedy under Kentucky's Blue Sky Law is limited by the three year statute of limitations in §292.480(3).

II.

We now must consider which statute of limitations should apply to a federal securities claim under §10(b) and rule 10b-5 by determining whether the implied remedy under Kentucky's Blue Sky Law or the common law fraud cause of action more nearly resembles the federal cause of action. This Court has previously chosen the statute of limitations applied to common law fraud actions when con-

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(Footnote continued from preceding page)

second and third factors—what was the legislative intent and what is legislative purpose—are logical questions to ask whether the court is implying a state cause of action or implying a federal cause of action. To that extent, Kentucky would probably follow *Cort* in determining whether or not a private action existed under §292.320(1) as, indeed, we have.

sidering Michigan and Ohio statutes. In each instance it made a careful examination of the state's law. Because the law of Kentucky differs from that of Michigan and Ohio, those cases are distinguishable.

In *Charney, supra,* this Court used the limitations period for common law fraud even though a fraud action was not identical to a rule 10b-5 action because Michigan had no provision similar to §10(b). After that case was decided, Michigan repealed its blue sky law and adopted the U.S.A. This Court again considered the limitations question in *IDS Progressive Fund, Inc.* v. *First of Michigan Corp.,* 533 F. 2d 340 (6th Cir. 1976). The Court continued to apply the common law fraud limitations period. It held Michigan still had no provision similar to §10(b), as §101 of U.S.A. enacted by Michigan was exclusively a criminal statute. Significantly, Michigan had also enacted §410(h) of U.S.A. precluding any implied remedies other than those in §410. The Court did not feel it had a sufficiently compelling reason to change the period applicable to federal securities claims in Michigan.

The Court used the same rationale in *Nickels* v. *Koehler Management Corp.,* 541 F. 2d 611 (6th Cir. 1976), *cert. denied,* 429 U. S. 1074 (1977), followed in *Gaudin, supra.* An earlier case. *Connelly* v. *Balkwill,* 279 F. 2d 685 (6th Cir. 1960), had applied without discussion Ohio's four year statute of limitations for fraud actions to a federal securities claim rather than the general six year statute of limitations. The limitations period of the blue sky statute was not raised in *Connelly.* Ohio also had a section similar to §410(h) of U.S.A. The Court in *Nickels* concluded both common law fraud and blue sky remedies were similar to a rule 10b-5 claim and held that common law fraud was sufficiently similar to rule 10b-5 claims to continue using the common law fraud limitations period. To change the statute of limitations for federal 10b-5 claims, would increase

uncertainty. In addition, *see United California Bank* v. *Salik*, 481 F. 2d 1012, 1015 (9th Cir.), *cert. denied*, 414 U. S. 1004 (1973); *but see Fox* v. *Kane-Miller Corp.*, 542 F. 2d 915 (4th Cir. 1976).

The present case does not involve a state blue sky law which precludes implied remedies similar to those implied under rule 10b-5. Rather, as we have held, it would permit such a remedy. Nor has this Court previously ruled on the appropriate statute of limitations to be applied in Kentucky. Thus, we are not limited in our choice by a desire to avoid increasing uncertainty.

Other circuits have chosen common law fraud limitations periods over blue sky limitations periods. *See McNeal* v. *Paine, Webber, Jackson & Curtis, Inc.*, 598 F. 2d 888 (5th Cir. 1979); *Clegg* v. *Conk*, 507 F. 2d 1351 (10th Cir. 1974), *cert. denied*, 422 U. S. 1007 (1975); *Salik, supra.* However, *Salik* applied the common law fraud limitations period because that period had been applied before California enacted its blue sky law and the Court did not want to change the federal statute of limitations every time the state changed its law. *McNeal* used the common law fraud limitations period because Georgia's Blue Sky Law was limited to an action for rescission and did not allow recovery for damages.

The majority of circuits have applied blue sky law limitation periods rather than limitation periods for fraud actions to rule 10b-5 claims. *See Morris* v. *Stifel, Nicholaus & Co., Inc.*, 600 F. 2d 139 (8th Cir. 1979); *Forrestal Village, Inc.* v. *Graham*, 551 F. 2d 411. 179 U. S. App. D.C. 225 (D.C. Cir. 1977); *LaRosa Building Corp., supra; Berry Petroleum Co.* v. *Adams & Peck*, 518 F. 2d 402 (2d Cir. 1975); *Hudak* v. *Economic Research Analysts, Inc.*, 499 F. 2d 966 (5th Cir. 1974), *cert. denied*, 419 U. S. 1122 (1975); *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F. 2d 123 (7th Cir. 1972); *Vanderboom, supra.* One court has applied the

state blue sky law statute of limitations to a federal securities claim arising under §17(a) of the 1933 Act. *See Newman* v. *Prior,* 518 F. 2d 97 (4th Cir. 1975). Most of these cases involved defrauded purchasers, but *Fox* involved a defrauded seller. These courts relied upon the state blue sky law because those laws had a common purpose with the federal securities laws, similar defenses, or similar remedies.

The purpose of the federal securities laws is to substitute the philosophy of full disclosure for that of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. *See Affiliated Uts Citizens of Utah* v. *United States,* 406 U. S. 128, 151 (1972). Both rule 10b-5 and the Kentucky Blue Sky Law deal with fraud in the sale of securities, whether perpetrated by seller or buyer.

Actions based on securities fraud are distinguishable from general actions for fraud. Some of the inhibiting strictures of the law of misrepresentation are relaxed under the blue sky law. *See Hutto* v. *Bockweg,* 579 S. W. 2d 382 (Ky. App. 1979). To sue for misrepresentation, the plaintiff must prove that the misrepresentation was made with knowledge of its falsity or under circumstances that do not justify a belief in its truth and that the plaintiff relied upon the misrepresentation to his detriment. *See Keck* v. *Wacker,* 413 F. Supp. 1377, 1383 (E.D. Ky. 1976); *Jo'Lee, Inc.* v. *Francke,* 531 S. W. 2d 711 (Ky. 1976); *Sanford Construction Co.* v. *S & H Contractors, Inc.,* 443 S. W. 2d 277, 231 (Ky. 1969). The blue sky act does not require the plaintiff to prove scienter—rather the defendant must prove he did not know or could not have reasonably known of the untruth or omission, *see Owensboro, supra,* 534 S. W. 2d at 791, nor does it require proof of reliance upon the misrepresentation. Ky. Rev. Stat. Ann. §292.480(1). One may sue for rescission under the common law of fraud, *see Keck,*

supra, or for actual damages sustained, *see Jo'Lee, supra; Sanford, supra,* 443 S. W. 2d at 236-37, 239. Under the blue sky law, a buyer may sue for the consideration paid upon tender of the securities. The buyer may only sue for damages if he no longer owns the security, to be measured by the amount that would have been available upon tender less the value of the security when the buyer disposed of them. Ky. Rev. Stat. Ann. §292.480(1).

A plaintiff bringing a suit under §10(b) and rule 10b-5 does not have to prove he relied upon omissions of material fact. *See Affiliated Ute Citizens, supra,* 406 U. S. at 152-54. However, he does have to prove scienter—mere negligence is not enough. *See Ernst & Ernst* v. *Hochfelder,* 425 U. S. 185 (1976). The Supreme Court left open the question whether proving recklessness would satisfy the scienter requirement. *See* 425 U. S. at 194 n. 12. Damages for the defrauded sellers are determined by the difference from the fair value of what was received and what would have been received had there been no fraud. *See Affliated Ute Citizens, supra,* 406 U. S. at 155.

Neither the Kentucky common law of fraud nor the blue sky law is exactly like the rule 10b-5 action. The blue sky law has the same language and the same specific purpose; the common law of fraud has a similar defense of lack of scienter. Other courts have held that the commonality of purpose of the blue sky law weighed more than the common defense of lack of scienter of the common law action. *See Morris, supra; Forrestal Village, Inc., supra; Berry Petroleum Co., supra.*

This Court has previously said that the broad remedial purposes of the federal securities laws are best served by longer, not shorter, statute of limitations, *See Nickels, supra,* 541 F. 2d at 618; *IDS Progressive Fund, supra,* 533 F. 2d at 344. In addition, *see Berry Petroleum Co., supra,* 518 F. 2d at 409; *Salik, supra,* 381 F. 2d at 1015. But the

reason for using the longer statute of limitations for a federal securities claim is to give the person with a federal claim at least as long an opportunity to sue as a person with a state claim. *See Berry Petroleum Co., supra,* 518 F. 2d at 409. The Kentucky Supreme Court has held that its blue sky law is the exclusive remedy for fraud in the sale of securities. *See Owensboro, supra,* 534 F. 2d at 791. The strict requirements of misrepresentation have been relaxed and the price exacted is a shortened statute of limitations, *Id.* A plaintiff is also relieved from proving all the elements of misrepresentation with his rule 10b-5 action; thus, it is reasonable to apply the shortened statute of limitations. Given that the language of §292.320 is nearly identical with rule 10b-5, that both statutes have the same purpose, and that neither requires the plaintiff to prove all that is required under common law of misrepresentation, we hold that the proper statute of limitations is the three year statute of limitations in Kentucky's Blue Sky Law, §292.480(3), and appellees' claims under §10(b) of the 1934 Act and rule 10b-5 are therefore time-barred. The decision of the District Court is reversed and the cause remanded for proceedings consistent with this opinion.

[DISSENTING OPINION]

JONES, Circuit Judge, dissenting: Because I believe the language of Kentucky's "Blue Sky" Statute evinces an unambiguous legislative intent to deny a private cause of action to defraud sellers of securities and because precedent in this Circuit establishes our policy in favor of longer, not shorter, statute of limitations in securities fraud cases, I respectfully dissent.

I.

Plaintiffs allege fraud in the sale of their securities in violation of §§10(b) and 14(c) of the Securities Exchange Act of 1934, 15 U.S.C. §78 *et seq.* The applicable statute of limitations period for plaintiffs' claims of fraud is the Kentucky statute of limitations for the state action which most closely resembles the federal claims and which best effectuate federal policy. *Nickels* v. *Kochler Management Corp.*, 541 F. 2d 611, 612, 615 (6th Cir. 1976).

Kentucky's "Blue Sky" Statute, Ky. Rev. Stat. Ann. §292.310 *et seq.*, applies a three-year limitations period to state law claims of securities frauds, however the statute does not provide a cause of action to defrauded sellers of securities. Clearly, as the majority asserts, a state statute that denies to these plaintiffs a claim for relief cannot be characterized as closely resembling their federal claims or as effectuating federal policy. Alternatively, plaintiffs have a claim for relief in common law fraud. The applicable statute of limitations is five years. Rather than apply this five-year statute of limitations to plaintiffs' federal securities law claim, the majority puts on its legislative robes, and, in violation of the most basic principles of statutory construction and established precedent in this Circuit, creates an implied cause of action for defrauded sellers of securities under Kentucky's "Blue Sky" statute.

II.

The threshold question in this case is whether to imply a cause of action for defrauded sellers of securities under the anti-fraud section of Kentucky's "Blue Sky" statute, §229.320(1), so that it may be construed to closely resemble federal claims and effectuate federal policy. Kentucky jurisprudence has not specifically addressed the question of implied causes of action in statutes. However, implying a cause of action in a statute is a task of statutory construc-

tion. To decide the question presented, Kentucky courts would apply basic principles of statutory construction and would reason from the criteria federal courts follow to imply causes of action in federal statutes.[1]

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[1]See *Touche Ross & Co.* v. *Reddington,* 99 S.Ct. 2479 (1979); *United States* v. *Naftalin,* 99 S.Ct. 2077 (1979); *Cannon* v. *University of Chicago,* 99 St.Ct. 1946 (1979); *Cort* v. *Ash,* 422 U. S. 66 (1975); and *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers,* 414 U.S. 453 (1974). The majority opinion dot not acknowledge or discuss these recent decisions.

In *Cort,* the Supreme Court established the following oft-cited four-prong inquiry to guide judicial decisions to imply private causes of action in federal statutes:

> In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff "one of the class for whose *especial* benefit the statute was enacted," *Texas & Pacific R. Co.* v. *Rigsby,* 241 U. S. 33, 39 (1916) (emphasis supplied)—that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? *See e.g., National Railroad Passenger Corp.* v, *National Assn. of Railroad Passengers,* 414 U. S. 453, 458, 460 (1974) *(Amtrak).* Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? See, *e.g., Amtrak, supra; Securities Investor Protection Corp.* v. *Barbour,* 421 U. S. 412, 423 (1975); *Calhoon* v. *Harvey,* 379 U. S. 134 (1964). And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be inappropriate to infer a cause of action based solely on federal law? See *Wheeldin* v. *Wheeler,* 373 U. S. 647, 652 (1963); cf. *J. I. Case Co.* v. *Borak,* 377 U. S. 426, 434 (1964); *Bivens* v. *Six Unknown Federal Narcotics Agents,* 403 U. S. 388, 394-395 (1971); *id.;* at 400 (Harlan J. concurring in judgment).
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> 422 U. S. at 78.

For an excellent analysis of precedent in this area, see Steinburg. *Implied Private Rights of Action Under Federal Law,* 55 The Notre Dame Lawyer 33 (1979).

The majority's holding is premised upon the Kentucky legislature's: (1) failure to enact a clause proscribing the implication of a private cause of action for defrauded sellers; and (2) enactment of a guide to courts to interpret the "Blue Sky" statute consistent with the federal securities acts and decisions of other state courts.

The majority's reliance on the Kentucky's legislature's failure to enact language prohibiting judicial creation of a private cause of action is misplaced. First, the primary principle of statutory construction is that legislative intent is ascertained from the words of the statute, rather than judicial surmising of what may have been intended but not expressed. Although §292.320 of Kentucky's "Blue Sky" statute prohibits fraud in the purchase or sale of securities, section 292.480 of the statute sets forth an express private cause of action to enforce the anti-fraud provisions which is explicitly limited to defrauded purchasers. As articulated in the seminal decision of *Cort* v. *Ash*, 422 U. S. 66 (1975):

> In situations in which it is clear that federal law has granted a class of persons certain rights, it is not necessary to show an intention to *create* a private cause of action, although an explicit purpose to *deny* such a cause of action would be controlling.

Id. at 82 (emphasis in original). In *Cort* the Supreme Court reaffirmed its earlier holding in *National Railroad Passenger Corp.* v. *National Association of Railroad Passengers*, 414 U. S. 453, 456 (1974); (*"Amtrak"*), that the enactment of an express private cause of action explicitly limited in scope is evidence of a purpose to deny any other

cause of action.[2] This frequently stated principle, derived from the ancient maxim—*expressio unius exclusio alterius*, is not alien to Kentucky law. *See Wade* v. *Commissioner*, 303 S. W. 905, (1957).

The application of this well settled principle to this case militates against judicial creation of a cause of action for defrauded sellers under the general anti-fraud clause of Kentucky's "Blue Sky" Statute. The language of the statute is clear and unambiguous. Where the express civil cause of action is, by its terms, limited to defrauded purchasers, I am extremely reluctant to imply a cause of action significantly broader than the remedy chosen by the legislature. Indeed, as stated by the Kentucky Supreme Court in *Thomas* v. *Fidelity & Casualty Co. of New York*, 258 Ky. 360, 80 S. W. 2d 8 (1935):

> The legislature has ample power, if it sees fit, to promulgate *additional* [causes of action] under its "Blue Sky" Statute. It is the sole judge in such matters, and where, as in the instant case, it has spoken in plain and unmista ble language, the courts are

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[2]Unfortunately, the majority's footnote four mischaracterizes my use of *Cort* and its progeny. I do not hold that those decisions are precedent governing the issue of whether to imply a cause of action for defrauded sellers pursuant to Kentucky's Blue Sky Statute. Rather, in the absence of a Kentucky jurisprudenre specifically addressed to the question of judicially implied causes of action, I conclude that Kentucky would find guidance in the "criteria federal courts follow to imply causes of action in federal statutes."

According to the majority, my "reliance" on *Cort* is misplaced because the State legislature possesses general police powers and the state courts make available common law and statutory remedies. It is ironic that the common law remedies of recission, restitution and fraud are the very reasons cited by the drafters of the Uniform Securities Act to purposefully deny to defrauded sellers a state statutory remedy.

without authority to engraft an exception upon the statute.

Id. at 10 (emphasis added).

Second, the legislative history cited by the majority is not clearly contrary to my textual analysis of the statute.[3] A preliminary draft of the statute contained a clause prohibiting judicial creation of private causes of action. The majority relies heavily upon the Kentucky legislature's failure to enact this provision. The "legislative history" cited by the majority is not a recitation of the Kentucky legislature's deliberations concerning enactment of its "Blue Sky" Statute. Rather, the legislative history is the draftsman's commentary to a proposed Uniform Securities Act drafted under the auspices of the National Commission of State Commissioners on Uniform State Laws. Whether the clause in question was a part of the legislation submitted to the legislature and subsequently deleted by passage of an amendment is uncertain. However, at least as important to an understanding of legislative intent as the possible amending of proposed legislation is the draftsman's commentary explaining the reason for not providing a civil cause of action to defrauded sellers:

> Although the lower federal courts have uniformly implied a civil cause of action against fraudulent buyers under the SEC rule, the federal courts when applying federal law do not have at their disposal all of the common-law and equitable remedies of deceit and recission which are available to the state courts without benefit of statute . . .

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[3]As stated in *Amtrak*, "even the most basic general principles of statutory construction must yield to clear contrary evidence of legislative intent." 414 U. S. at 458.

Loss, *Commentary on the Uniform Securities Act* at 8 (1976). *See also Id.* at §410(a), p. 147. Before implying a cause of action for defrauded sellers, there ought to be an articulation of the inadequacies of the intended remedies available to defrauded sellers.

I conclude from my examination of the statute and its legislative history that there is a legislative intent to deny a cause of action to defrauded sellers of securities.[4]

The majority also relies upon a policy statement in Kentucky's "Blue Sky" Statute that courts ought to interpret the statute consistent with the federal securities statutes and state court decisions construing sister states' "Blue Sky" statutes, Ky. Rev. Stat. Ann. §292.530. Causes of action have been judicially implied pursuant to the general anti-fraud provision of the federal securities act. However, the federal judiciary's role in creating causes of action under federal securities statutes is distinguishable. The above-cited commentary to the Uniform Securities Code explains that federal courts are without the traditional arsenal of state law causes of action and remedies to prevent fraud in securities transactions. In addition, the anti-fraud provision of the federal securities act did not provide an explicit cause of action limited to particular parties.[5]

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[4]This case, therefore, is clearly distinguishable from *Cannon*, wherein Justice Stevens, writing for the majority, stated:

> [L]egislative history of a statute that does not expressly create or deny a private remedy will typically be silent or ambiguous on the question . . . But this is not the typical case. Far from evidencing any purpose to *deny* a private cause of action, the history of Title IX [20 U.S.C. §1681] plainly indicates tht Congress intended to create such a remedy.

99 S. Ct. at 1956 (emphasis in original).

[5]*See J. I. Case* v. *Borak*, 377 U. S. 426 (1964).

III.

Assuming *arguendo* that neither the language enacted nor the legislative history offer definitive guidance, it is proper to consider what may be described as policy considerations. *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U. S. 723, 737 (1975).

Three cases in this Court have considered the choice of one of several state statutes of limitations to federal securities claims. *Nickels* v. *Koehler Management Corp.,* 541 F. 2d 611 (6th Cir. 1976) (construing Ohio law), *I.D.S. Progressive Fund, Inc.* v. *Frost of Michigan Corp.,* 533 F. 2d 340 (6th Cir. 1976), (construing Michigan law), and *Charney* v. *Thomas,* 372 F. 2d 97 (6th Cir. 1967), (construing Michigan law). The language of *I.D.S. Progressive Fund, Inc.* articulates the favored policy in this Circuit: "the broad remedial purposes of the federal securities law are best served by a longer not shorter statute of limitations." 533 F. 2d at 344. The majority's opinion overrules the well established policy of our Circuit without any explanation of the inappropriateness of applying longer statutes of limitation to remedial statutes.

Accordingly, I would affirm the judgment of the district court and remand the case for proceedings consistent with my opinion.

SECURITIES EXCHANGE ACT OF 1934, § 10
15 U.S.C. §78

Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

SECURITIES EXCHANGE COMMISSION RULE 10b-5
17 C.F.R. §240.10b-5

Employment of manipulative and deceptive devices

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

THE SECURITIES ACT OF KENTUCKY
Kentucky Revised Statute Chapter 292, Subsection 320(1)
(as enacted Kentucky Acts 1960, ch. 110, §18;
1972, ch. 265, §14)

Fraudulent and other prohibited practices.—(1) It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly:

(a) To employ any device, scheme, or artifice to defraud;

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

THE SECURITIES ACT OF KENTUCKY
Kentucky Revised Statute Chapter 292, Section 480
(as enacted Kentucky Acts 1960, ch. 110, §18;
1972, ch. 265, §14.)

Civil liabilities.—(1) Any person, who offers or sells a security in violation of this chapter or of any rules and regulations promulgated hereunder or offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made in the light of the circumstances under which they are made not misleading (the buyer not knowing of the untruth or omission) and who does not sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of the untruth or omission is liable to the person buying the security from

him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six per cent (6%) per annum from the date of payment costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security. Damages are the amount that would be recoverable upon a tender less (a) the value of the security when the buyer is disposed of it and (b) interest at six per cent (6%) per annum from the date of disposition.

(2) Every person who directly or indirectly controls a seller liable under subsection (1), every partner, officer or director (or person occupying a similar status or performing similar functions) or employe of such a seller who materially aids in the sale, and every broker-dealer or agent who materially aids in the sale is also liable jointly and severally with and to the same extent as the seller, unless the nonseller who is so liable sustains the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

(3) Any tender specified in this section may be made at any time before entry of judgment. Every cause of action under this statute survives the death of any person who might have been a plaintiff or defendant. No person may sue under this section more than three (3) years after the contract of sale. No person may sue under this section (a) if the buyer received a written offer, before suit and at a time when he owned the security, to refund the consideration paid together with interest at six per cent (6%) per annum from the date of payment, less the amount of any income received on the security, and he failed to accept the offer within thirty (30) days of its receipt, or (b)

if the buyer received such an offer before suit and at a time when he did not own the security, unless he rejected the offer in writing within thirty (30) days of its receipt.

(4) No person who has made or engaged in the performance of any contract in violation of any provision of this chapter or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, may base any suit on the contract. Any condition, stipulation or provision binding any person acquiring any security to waive compliance with any provision of this chapter or any rule or order hereunder is void.

KENTUCKY REVISED STATUTES
CHAPTER 413

Limitation of Actions, Subsection .120(2) and (12)

Actions to be brought within five years.—The following actions shall be commenced within five (5) years after the cause of action accrued:

* * * * * * *

(2) An action upon a liability created by statute, when no other time is fixed by the statute creating the liability.

* * * * * * *

(12) An action for relief or damages on the ground of fraud or mistake.